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Re-regulation of Infrastructure Investment: Issues for the International Lawyer

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Foreign investment is prone to regulatory risk. This is particularly so in respect of the utility sector, given the immovability of the infrastructure and the strong public interest in its regulation. Re-regulation of infrastructure investment can take many forms, including legislative or regulatory changes that foster competition previously not existing or environmental standards more onerous as well as increased tariffs and taxation. Unbargained for re-regulation always affects returns on the relevant investment.

State Sovereignty

It is the sovereign power of a State to amend its laws and regulations (and its contractual, indeed treaty, commitments). If the re-regulation concerns taxation, then even developed countries are unwilling to give up their sovereign prerogative. Article 1 of Protocol No1 to the European Convention on Human Rights[1] specifically states that the general interest of the State and its right to secure taxes override an individual's right to his or her property from state interference.[2]

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[1] Convention for the Protection of Human Rights and Fundamental Freedoms (ETS No005), done at Rome on 4 November 1950 and entered into force on 3 September 1953. The Convention was subsequently amended by Protocol No11 (ETS No155) to the Convention, done at Strasbourg on 11 May 1994 and entered into force 1 November 1998, to the effect that the then existing supervisory mechanism, consisting of a European Court of Human Rights and a European Commission of Human Rights, be restructured and replaced with a single permanent European Court of Human Rights. For an account on the theory and practice of the European Convention on Human Rights, see P. van Dijk and G. J. H. van Hoof, *Theory and Practice of the European Convention on Human Rights* (3rd ed.) (The Hague: Kluwer International, 1998).

[2] Protocol No1 to the Convention for the Protection of Human Rights and Fundamental Freedoms (ETS No009), done at Paris on 20 March 1952 and entered into force on 18 May 1954. Article 1 of Protocol No1 states that "[e]very natural or legal person is entitled to the peaceful enjoyment of his possessions. No one

However, it is a well-established principle of international law that a State may in no circumstance disregard its international obligations merely on account of its municipal laws that may allow or dictate otherwise. As the Permanent Court of International Justice in its 1932 advisory opinion in *Treatment of Polish Nationals in the Danzig Territory*[3] declared, "a State cannot adduce as against another State its own Constitution with a view to evading obligations incumbent upon it under international law or treaties in force".[4] As the Harvard Law School Research in International Law concluded in 1935, "if a constitutional provision existing at the time a treaty is entered into cannot be relied upon to avoid performance of provisions in the treaty with which it conflicts, it must be even clearer that constitutional provisions adopted subsequent to the conclusion of the treaty are not to be relied upon for that purpose. Were the contrary principle to prevail, a State would have only to write into its constitution provisions which conflicted with its existing treaties in order to be freed from the obligations imposed by those treaties".[5] The Harvard Research went on to point out that "if a State cannot plead provisions in its fundamental law in justification of a failure on its part to perform its binding treaty obligations, it follows *a fortiori* that it cannot rely upon provisions in its ordinary legislation for any such purpose".[6]

In entering into an agreement with foreign investors, the host State exercises its attribute as sovereign State. This attribute, however, includes its consent and obligation to abide by agreements into which it has entered (*pacta sunt servanda*). The agreement may stipulate that the host State's and/or another State's laws and regulations apply. The agreement may also specify that international law and/or general principles of law shall control, assist or be disregarded.

The Need for a Stabilisation Clause

Lawyers are therefore engaged to structure a legal framework, with reference to international law, that will protect foreign investors from any unanticipated re-regulation by the host State. In particular, foreign investors may ask that a stabilisation clause be stipulated in their agreement with the host State. Such a clause purports

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shall be deprived of his possessions except in the public interest and subject to the conditions provided for by law and by the general principles of international law. The preceding provisions shall not, however, in any way impair the right of a State to enforce such laws as it deems necessary to control the use of property in accordance with the general interest or to secure the payment of taxes or other contributions or penalties".

[3] *Treatment of Polish Nationals and Other Persons of Polish Origin or Speech in the Danzig Territory*, PCIJ Ser.A/B Judgments, No44, 4 (1932).

[4] *Ibid,* 24.

[5] Harvard Law School Research in International Law, Part III: Law of Treaties, 29 *Supplement to the American Journal of International Law* (1935), 649, 1032.

[6] *Ibid,* 1033.

that future legislative or regulatory changes in the State will be ineffective against them.

A stabilisation clause is of pivotal importance in guaranteeing the rights of foreign investors. Hence, adequate attention must be paid to the drafting of a stabilisation clause. Seeking to counterbalance the host State's sovereign powers, such a clause will be interpreted by domestic and foreign courts and arbitral tribunals in the most restrictive manner. It therefore must cover all of the possibilities that may lead to undesirable re-regulation. The consequences of re-regulation must also be addressed before it occurs, and agreed compensation must be spelt out at this stage.

In addition, bilateral investment treaties may be entered into that set forth the rights of foreign investors of the respective signatory States. These treaties invariably contain a stabilisation clause.

A number of countries have also taken the initiative of adopting investment codes that serve the purpose of a stabilisation clause. Nonetheless, these investment codes, being ordinary laws, are themselves subject to legislative repeal. Thus, a stabilisation clause in an agreement between foreign investors and the host State remains necessary.

Fundamental Change of Circumstances

In justifying re-regulation, the host State may claim that a fundamental change of circumstances (*rebus sic stantibus*) exists. A fundamental change of circumstances allows a breach or cessation of certain obligations owed by a State under a bilateral or multilateral treaty.

Article 62(1) of the Vienna Convention on the Law of Treaties,[7] providing for the defence, states that "[a] fundamental change of circumstances which has occurred with regard to those existing at the time of the conclusion of a treaty, and which was not foreseen by the parties, may not be invoked as a ground for terminating or withdrawing from the treaty unless (a) the existence of those circumstances constituted an essential basis of the consent of the parties to be bound by the treaty; and (b) the effect of the change is radically to transform the extent of obligations still to be performed under the treaty".[8] In its 1997 decision in *Gabčíkovo–Nagymaros Project*,[9] the International Court of Justice ruled that "a fundamental change of circumstances must have been unforeseen; the existence of the circumstances at the time of the Treaty's conclusion must have constituted an essential basis of the consent of the parties to be bound by the Treaty".[10] Many provisions of

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[7] Done at Vienna on 23 May 1969 and entered into force on 27 January 1980.

[8] *Ibid,* Art62(1).

[9] *Case concerning the Gabčíkovo–Nagymaros Project* (*Hungary v Slovakia*), *ICJ Reports* 1997, 3.

[10] *Ibid,* 65.

the Vienna Convention, including Article 62, are taken as codification of customary international law on the law of treaties;[11] the defence thus need not be expressly specified in a treaty. Nonetheless, Article 62(1) is couched in negative terms, which indicates that the defence will be allowed only in exceptional circumstances.[12] If the change is brought forth as a result of a breach of international law by the State invoking the defence, then the defence will not be available.[13]

The Rights of Foreign Investors under International Law

As States continue to be the primary actors and subjects of international law, barring a valid arbitration agreement with the host State a foreign investor may need to rely on its own national State to espouse its dispute with the host State.[14] Under customary international law, a national State has full liberty whether or not to do so. [15]

Nonetheless, foreign investors are entitled to the international minimum standard of treatment by the host State. In two separate decisions in 1986,[16] the European Court of Human Rights concluded that the international minimum standard of treatment does not apply to an investor operating within its own national State, and that any difference in treatment between foreign and domestic investors does not constitute discrimination contrary to the European Convention on Human Rights. In the opinion of the Strasbourg court, the international minimum standard allows foreign investors to resort directly to the European Convention to enforce their rights on the basis of the standard, without which they would have to seek diplomatic protection which may not be forthcoming. The difference does not constitute discrimination because it has an "objective and reasonable justification". The fact that nationals and not foreign investors may be in a position to influence public policy through elections also, it was held, legitimatises such a difference in treatment. The court on both occasions found its judgment to be commensurate with State practice. However, it ought to be noted that direct recourse to the European Convention is available in Council of Europe jurisdictions only.

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[11] *Ibid,* 38.

[12] *Ibid,* 65.

[13] Vienna Convention on the Law of Treaties, Art62(2)(b).

[14] The Permanent Court of International Justice in *Case of the Mavrommatis Palestine Concessions* (*Greece v United Kingdom*), PCIJ Ser.A Judgments, No2 (1924), 6, indicated, at 12, that "[b]y taking up the case of one of its subjects and by resorting to diplomatic action or international judicial proceedings on his behalf, a State is in reality asserting its own rights–its rights to ensure, in the person of its subjects, respect for the rules of international law".

[15] *HMHK v The Netherlands*, 94 *International Law Reports* 342 (1984), 345.

[16] *James v United Kingdom*, 8 EHRR 123 (1986); *Lithgow and Others v United Kingdom*, 8 EHRR 329 (1986).

States are not required to compensate when re-regulating areas that are in the public interest, such as the environment and sustainable development, public health and safety, or public order. It is thus reasonable to conclude that a stabilisation clause, in either a bilateral investment treaty or a foreign investment agreement, will not survive any re-regulation in relation to these areas. As early as 1887, the United States Supreme Court decided that "[a] prohibition simply upon the use of property for purposes that are declared by valid legislation to be injurious to the health, morals, or safety of the community cannot in any just sense be deemed a taking or an appropriation of property for the public benefit. Such legislation does not disturb the owner in the control or use of his property for lawful purposes, nor restrict his right to dispose of it, but is only a declaration by the State that its use by anyone, for certain forbidden purposes, is prejudicial to the public interest".[17]

To be considered lawful under international law, any re-regulation of foreign investment must be non-discriminatory. The host State must accord foreign investors conditions that are no less favorable than it does its own nationals in similar circumstances. It is well established that governmental action taken against foreign investors for purely extraneous political reasons is discriminatory and violates international law.[18] Access to competent independent judicial process must be allowed; otherwise a denial of justice, a separate and distinct international wrong, will be committed, engaging the host State's State responsibility. Nonetheless, State responsibility will be engaged only after the exhaustion of all local remedies available in the host State.[19]

Re-regulation may amount to expropriation if it entails a substantial diminution in the values of the property. It is expropriation also if the re-regulation substantially interferes with the investors' use and enjoyment of their property. As the Iran-United States Claims Tribunal pointed out, "it is recognized in international law that measures taken by a State can interfere with property rights to such an extent that these rights are rendered so useless that they must be deemed to have been expropriated, even though the State does not purport to have expropriated them and the legal title to the property formally remains with the original owner".[20]

In 1926, the Permanent Court of International Justice affirmed that international law demands respect for private property rights.[21] In its 1962 resolution on States' permanent sovereignty over natural resources,[22] the United Nations General As-

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[17] *Mugler v Kansas*, 123 US 623 (1887), *per* Harlan J., 668–69.

[18] *BP Exploration Company (Libya) Limited v Government of the Libyan Arab Republic*, 53 *International Law Reports* 297 (1973), 329; *Libyan American Oil Company (LIAMCO) v Government of the Libyan Arab Republic*, 62 *International Law Reports* 140 (1977), 194–95.

[19] *Interhandel Case* (*Switzerland v United States of America*), ICJ Reports 1959, 6, 27.

[20] *Starrett Housing Corporation and Others v The Government of the Islamic Republic of Iran and Others*, 4 *Iran-U.S. Claims Tribunal Reports* 122 (1983), *per* Chairman Lagergren, 154.

[21] *Case concerning Certain German Interests in Polish Upper Silesia (Merits)* (*Germany v Poland*), PCIJ Ser.A Judgments, No7 (1926), 4, 21–22.

[22] UN GA Res 1803 (XVII) of 14 December 1962.

sembly mandated "appropriate compensation" for expropriation of investment.[23] Under customary international law, wronged investors are entitled to "prompt, adequate and effective compensation". The Energy Charter Treaty,[24] underscoring the concerns of the energy sector, also provides for compensation.[25] Compensation for expropriated investment must amount to the fair market value.[26] Compensation, to be considered adequate, must also be payable for loss of expected profits, provided that these expected profits are not too remote or speculative.[27]

In its arbitral award between LIAMCO and Libya in 1977,[28] the tribunal deduced that Libya in its arbitration agreement with LIAMCO had agreed to the application of general principles of law which included equity.[29] Thus, the tribunal found it both reasonable and just that the formula of "equitable compensation" should be adopted in determining suitable damages.[30]

Enforcement of Entitlement to Compensation

To be meaningful, an entitlement must be capable of being enforced. The peculiar vulnerabilities of foreign investors in the host State, particularly in respect of access to competent independent judicial process, have been highlighted. A foreign investment agreement, which may be reinforced by a bilateral investment treaty, will therefore invariably stipulate that international arbitration be the final and exclusive method in settling any dispute between the particular foreign investors and the host State.

Under customary international law, an arbitration clause has an independent character and thus survives the termination of the agreement containing it and continues to be in force after any such termination. The governing laws and place of the arbitration will have been agreed upon by the parties in, or determined by the arbitral tribunal so created by, the arbitration agreement.[31]

Article V of the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards[32] states that recognition or enforcement may be refused

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[23] *Ibid,* para 4.

[24] Done at Lisbon on 17 December 1994 and entered into force on 16 April 1998.

[25] *Ibid,* Arts12 and 13.

[26] *Norway v United States (Requisition of Shipbuilding Contracts Case)*, 1 *Annual Digest of Public International Law Cases* 189 (1922), 189.

[27] *United States of America (on Behalf of P. W. Shufeldt) v Republic of Guatemala*, 5 *Annual Digest of Public International Law Cases* 179 (1930), 181–82.

[28] *Libyan American Oil Company (LIAMCO)* v *Government of the Libyan Arab Republic*, 62 *International Law Reports* 140 (1977).

[29] *Ibid,* 175 and 209.

[30] *Ibid,* 209–10.

[31] *Ibid,* 176–80.

[32] Done at New York on 10 June 1958 and entered into force on 7 June 1959.

on any of such grounds as that the arbitration clause is not valid under the stated governing laws of arbitration or otherwise under the laws of the place of arbitration;[33] that the arbitration was held in want for due process[34] or in excess of jurisdiction;[35] that the subject-matter of the award is not arbitrable under the laws of the State where recognition and enforcement is sought;[36] or that the recognition and enforcement of the arbitral award would be contrary to the public policy of the State where recognition and enforcement is sought.[37]

The United States District Court for the District of Columbia refused to enforce the aforementioned arbitral award between LIAMCO and Libya, for the subject-matter of the award, ie, nationalisation, was an act of State and therefore not arbitrable under American law.[38] The award was also refused enforcement in Switzerland. The Swiss Federal Supreme Court found that there was not a sufficient legal relationship between the award and Switzerland as required by Swiss law for the award to be capable of enforcement in Swiss courts, even though the arbitration took place in Geneva.[39]

Accordingly, with the wide powers which sovereign States possess in regulating foreign investment, caution must be accorded also the drafting of the arbitration clause, the ultimate shield for foreign investors from arbitrary re-regulation by the host State.

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[33] *Ibid,* ArtV(1)(a).

[34] *Ibid,* ArtV(1)(b).

[35] *Ibid,* ArtV(1)(c).

[36] *Ibid,* ArtV(2)(a).

[37] *Ibid,* ArtV(2)(b).

[38] *Libyan American Oil Company v Socialist People's Libyan Arab Jamahiriya,* formerly *Libyan Arab Republic*, 482 F.Supp. 1175 (1980).

[39] *Socialist Libyan Arab Republic Jamahiriya v Libyan American Oil Company (LIAMCO)*, 62 *International Law Reports* 228 (1982).

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European Business Law Review specializes in business law, broadly defined and including both European Community Law and the laws of the member States and other European countries. The editors attempt to identify issues which are of interest to practitioners and scholars and to strike a balance between scholarship, policy discussion and the needs of the practitioner. These issues may concern public or private law, domestic, European or international law. In this wide area, the *Review* moves freely over the boundaries that divide the law.

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